PIRINC

Don't Sell the SPR to Balance the Budget

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Introduction

The Senate's Republican majority has put forward a budget that correctly seeks to reduce the deficit and its drag on the U.S. economy. In so doing, however, it proposes to sell off a portion of the Strategic Petroleum Reserve, a mechanism designed to help the economy during an oil disruption. Meeting the short-term goal, it will compromise the tools available for the long-term benefit of the economy.

The Senate's Republican budget proposes to sell Strategic Petroleum Reserve (SPR) volumes held at Weeks Island. Soon-to-be decommissioned, the Weeks Island site contains 72 million barrels of crude oil. The Administration has proposed the sale of approximately 7 million barrels to finance the decommissioning, including moving the remaining 65 million barrels of oil to the SPR's Big Hill facility. The Senate proposal would sell 62 million barrels. The budget proposed in the House of Representatives does not contain an analogous provision. (The Administration is opposed to the sale of more than the volume of oil needed to pay for decommissioning.)

This Senate sale, while for a limited volume, could be the camel's nose under the tent, the beginning of the total liquidation of the SPR. The fact that the Weeks Island volumes must be moved gives no justification for selling them; there is ample room at the Big Hill facility. What will the next justification for liquidation of SPR volumes be? The damage to the economy during an oil disruption if the SPR is not available to mitigate the impact will be a high multiple of the revenue benefit from the sale.

The SPR is the nation's insurance policy against the economic dislocations of an oil supply interruption. As such, it must be maintained in full force. Compromising this long-term and proven program is short-sighted.

SPR is an Insurance Policy

The nation wisely decided in 1975 to create a Strategic Petroleum Reserve. In the enabling legislation, the Energy Policy and Conservation Act of 1975, Congress found that "the storage of substantial quantities of petroleum products will diminish the vulnerability of the United States to the effects of a severe energy supply interruption, and provide limited protection from the short-term consequences of interruptions in supplies of petroleum products."

The Congress recognized that in the wake of the Arab oil embargo of 1973-4, the nation had suffered significantly from the higher prices and product shortages. The National Petroleum Council's 1987 report *Factors Affecting U.S. Oil and*

Gas Outlook estimated that the economy in 1973-75 suffered the worst recession of the post-World War II period to that time; GNP had shrunk 2.5% by 1976, unemployment increased by 1.5 percentage points, inflation (CPI) rose 3 percentage points. During the 1979 oil disruption, following the Iranian revolution, private companies engaged in rational and prudent inventory behavior -- husband your stocks for a rainier day. The resultant inventory accumulation exacerbated the market shortage. (The SPR was not yet ready for use in 1979).

Thus, it became increasingly apparent that government-owned and -controlled stocks would mitigate the impact of a supply disruption in two ways: by increasing physical supplies of oil and hence lowering the market-clearing price, and by putting that oil into markets at precisely the time that private companies would be most fearful of depleting their own stocks. It also provides a window of time to look for diplomatic solutions to international conflicts. Finally, the treaty among the International Energy Agency signatories requires that each nation have in place a mechanism to share an oil supply interruption; the U.S. use of the SPR obviates the need for a cumbersome and unworkable demand-reduction program.

The SPR Has Proven Itself

Even these truths about the benefits of the SPR, however, were only theoretical until Iraq's invasion of Kuwait. The existence of the SPR provided foreign policy flexibility during Operation Desert Shield. The use of the SPR at the outset of Operation Desert Storm in January 1991 provided an instantaneous counter force to the expected market panic, even though the volumes finally sold were small. (Had it been used during the third quarter of 1990, the negative economic impact of the post-invasion price spike would have been significantly moderated.)

Therefore, the SPR has always been an insurance policy. In 1991, it proved itself as an insurance policy that will pay off on its claims. Like any insurance policy, it must be kept in force to be useful -- not reduced, not sold off.

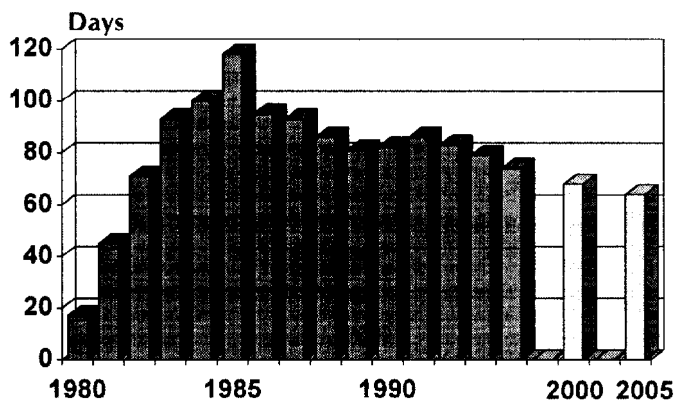
The absence of the SPR, furthermore, would limit the foreign policy options available to the U.S. and would require the U.S. to undertake other, more expensive and onerous, mitigation measures during an oil supply disruption or suffer the full force of the economic dislocations resulting from the price shock.

SPR facilities are designed to hold 750 million barrels. At 592 million barrels, the SPR has room for additional oil acquisition. The days' import cover of the SPR has been declining. In 1986, the SPR inventories were the equivalent of 95 days of net imports. By 1994, days' cover had fallen to 74 days. If SPR volumes remain at present levels, they will be sufficient to cover 68 days of the

Energy Information Administration's projected net imports in 2000. (See chart.) This declining trend impairs the effectiveness of the SPR, and may even make policy-makers reluctant to use it early and decisively during a crisis. Hence, the Congress should look to building SPR volumes and maintaining the facilities, not to liquidating this vital tool.

Days of Net Import Protection

SPR Inventory/Daily Net Oil Imports



Data for 2000 and 2005 based on Energy Information Administration's Reference Case, *Annual Energy Outlook 1995*

The Futures Market is No Substitute for the SPR

Some analysts have theorized recently that the SPR could be replaced by the diligent use of the now-mature futures market. The futures markets, vital as they are to the current oil market, would be no substitute for the SPR, because *physical volumes* are the only salve to an overheated market during a supply crisis. Futures transactions provide no incremental supply to the system. Thus, while futures transactions can effectively reduce a corporation's or consumer's exposure to price fluctuations (and provide ancillary benefits to the market, such as price discovery/transparency), they do not dampen the price move, *i.e.*, change the market-clearing price.

The futures market is by nature balanced -- the "long" (buy) transactions match the "short" (sell) transactions. During a sharp price change, therefore, there are winners and losers, but the system by definition comes to a zero-sum game. This contrasts with the physical market. During normal times, markets are balanced, of course. A supply disruption, however, is like a game of musical chairs -- the supply loss takes a consumer's chair away. The market will rebalance at a higher price because a consumer drops out of the game. In a supply crisis, some companies might try to take physical delivery of volumes purchased in futures transactions, yet those volumes would effectively not be available. Only the SPR would actually put a chair back on the floor in the form of physical supply.

An SPR Sale Would Hurt Domestic Producing Regions

The Administration recognized in planning for its sale of Weeks Island oil to pay for the facility's decommissioning that the oil would have to be sold in phases, to minimize the negative impact on domestic producers and the regional economies they support. The Administration's sale volume, estimated at 7 million barrels, was predicated on the cost of decommissioning.

If the Senate's much higher volume, 62 million barrels, were sold over a year, the additional supply would equal 170,000 B/D: 20% of recent Gulf of Mexico production; as much as the combined production from the headline-grabbing Auger (at current levels) and Mars (at 1996's planned Phase I levels) fields in the U.S. Gulf; as much as the current production from the venerable Brent field in the North Sea, and so on. Thus, the SPR sale volume would be equal to the output from world-class production plays. The timing and pace of the sale may be dictated by the speed of the deterioration at Weeks Island. Moving so large a volume onto the market will lower prices significantly, with attendant undesirable effects on domestic producers and producing regions.

Conclusion

The Senate's Republican budget seeks to help the economy by reducing the deficit. Its proposal to sell off a portion of the Strategic Petroleum Reserve, however, will do just the opposite for the economy. Designed to reduce the impact of an oil supply disruption, the SPR helps the economy during an emergency. Like an insurance policy, the benefits appear only potential, even though the very existence of a strong SPR shapes policy options available to the U.S., its allies, and potential aggressors. When the SPR is needed, however, the benefits are incontrovertibly real and irreplaceable. Only the Strategic Petroleum Reserve can provide additional physical volumes during a disruption, and hence only the SPR can calm markets, provide time to explore solutions to international crises, and cushion the impact of hard decisions affecting the supply of oil, such as those made during the Persian Gulf conflict. Selling SPR volumes, while gaining a cash infusion, will impose a long-term cost.